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In Practice

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Negative interest rates: where are we now?

In this In Practice article, the authors consider the effect of negative interest rates in transaction documents, particularly in documents that pre-date industry-recommended changes.

It has been over four years since the global financial markets first encountered a negative LIBOR rate for the Swiss Franc. This was swiftly followed by negative rates being published for LIBOR and EURIBOR as result of activities of European Central Bank. In response, both the Loan Markets Association (LMA) and International Swaps and Derivatives Association, Inc (ISDA) have published recommended changes to the industry-standard documentation with the aim of providing contractual certainty to market participants.

Notwithstanding the availability of contractual solutions, such as the ISDA Collateral Agreement Negative Interest Protocol (discussed below), there still appears to be much uncertainty and even disagreement between contracting parties as to the effect of negative interest rates in transaction documents, particular those that pre-date, or do not include, industry-recommended changes.

At the same time, economists are suggesting that long held expectations regarding the potential impact of a perpetual negative benchmark on recovering economies are not as extreme as expected, and that the risk of medium to long term liquidity problems for economies with negative interest rates may be much lower than thought. If these early economic analyses are borne out, then use of negative interest rates by central banks may move from short-term reaction to longer-term strategy options. The recent action taken by Sweden's Riksbank to extend quantative easing bonds buying programme by SEK65bn is an example.

CONTRACTUAL SOLUTIONS TO NEGATIVE INTEREST RATE UNCERTAINTY

We consider below the three main market-led drafting solutions available under the ISDA and LMA documentation structure.

The first is the application of the "Negative Interest Rate Method" prescribed by the 2006 ISDA Definitions which will automatically apply to all swap transactions incorporating the definitions, unless the parties specify otherwise.

Under the Negative Interest Rate Method, where a party (the Floating Rate Payer) would normally be required to pay interest in respect of the floating leg of the interest rate of a derivative transaction, but at the relevant date, the amount payable is a negative number (either as a result of a negative interest rate or due to the addition of a negative spread to a positive interest rate), then the "Floating Rate Payer" is deemed not to owe anything, and the other party is instead required to pay the absolute amount corresponding to the negative number to the other party – in simple terms, a reversal of the normal interest burden.[1]

Another available option under the 2006 ISDA Definitions is for the parties to specify the "Zero Interest Rate Method". This variant relieves a Floating Rate Payer from the obligation to pay interest on a relevant payment date if the amount payable is negative, but does not require the other party to "make up" the payment in a reversal of the normal interest burden as described above.[2]

The second solution, also promulgated by ISDA, is the May 2014 "Collateral Agreement Negative Interest Protocol" designed to be used to modify ISDA compliant collateral agreements, including the Credit Support Annex.

The Protocol can be used to amend the Interest Amount section of each collateral agreement entered into in order to add the concept of a negative Interest Amount (defined as the "AV Negative Interest Amount") in a way very similar to the 2006 ISDA Definitions, so that the person who would ordinarily receive a positive Interest Amount is required to transfer to the other the absolute amount corresponding to the AV Negative Interest Amount. The requirement to post this amount is then discharged by a reduction in the balance of the amount of collateral posted or transferred by the payer.

Finally, the LMA English law-governed syndicated facility agreement contains an option for contracting parties to include a "Zero Floor" interest provision. If included, any negative benchmark (eg LIBOR, EURIBOR) will be deemed to be zero, with consequent effect on any required payments under the facility.

INTERPRETATION ARGUMENTS IN RESPECT OF UN-AMENDED CONTRACTS

In circumstances where amendment of existing contracts is not possible (or cannot be agreed between the parties), the question that is increasingly being raised, is whether some form of interest floor could or should be implied such that the calculation of the interest amount payable should take into account the effect of a negative interest rate? If so, should the implied term lead to a zero interest payment or should it adopt the reversal approach so that the other party is required to make an absolute payment in respect of a corresponding negative interest amount?

The starting point for this analysis, under English law, is that an English court may imply a term into a commercial contract in certain specific circumstances – such as when required by statute, on the basis of usage and custom or based on a previous course of dealings. The most likely ground which would be relevant to negative interest rate issues is when the court considers that a term should be implied in order to reflect the intention of the parties, a so-called "term implied in fact". It is important to note that the clear message from the English case law is that terms will only be implied into a specific contract in order to fill a gap in the contract's drafting to reflect the parties' intentions when the contract was first entered into. The

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court will not imply a term into a contract simply because the court thinks that it would have been reasonable for the parties to have done so, or in light of subsequent developments not within the parties' reasonable contemplation at the time the contract was entered into. This second point alone may well be a significant issue to overcome for any implied term arguments in respect of longstanding contracts, but it will heavily depend on the circumstances and background to any particular contract.

For contracts entered into after the market availability of the various contractual solutions highlighted above, any claim for an implied term will need to establish why an express term was not negotiated in the circumstances.

Part of the analysis that an English court might undertake would be to consider the overall impact of any such implied term. Just taking as an example, the LMA English law-governed syndicated facility agreement referred to above, the implication of a negative interest rate term in the absence of a "Zero Floor" provision would raise several questions, including whether taking into account a negative interest rate benchmark would result in a payment to be made by a lender (because the margin is completely reduced by the benchmark). In the context of a market standard facility agreement, it would be a somewhat odd outcome to expect the lender to make a payment to the borrower since interest is generally only payable by a borrower to the lender.

However, that analysis may well be different under the English law governed ISDA 1995 Credit Support Annex (CSA) where, generally, interest amounts can be paid by either party to the agreement depending on which party has posted collateral and the amount of interest accrued on the collateral transferred. A transferee is usually required to transfer accrued interest to the transferor at the times nominated in the agreement. If a CSA is not subject to the ISDA protocol could the transferor (who would have to make a payment if the interest were negative) argue that a "Zero Floor" is implied? On a literal construction, this would be a difficult argument to make since there is no reason why the transferor of collateral would not be expected to make such a payment, unlike a lender in respect of a negative interest payment. This is indeed the outcome contemplated by the Protocol, but is it the commercial outcome expected by the contracting parties? The oddity here is that a transferor is required to post collateral to support its trade but in the instance where the interest rate is zero, the transferor will also be required to pay interest in respect of the collateral which it posted.

These potential basic situations underline some of the immediate difficulties for parties seeking to argue for specific implied terms in respect of negative interest rates post-contract. Accordingly it will inevitably be better to deal with such issues from the outset. However, if this period of negative interest rates does continue into a medium to long term economic cycle, we do expect to see more uptake of the existing contractual amendment solutions as market participants seek certainty on this issue.

Finally, we note that ISDA, following the call for benchmark reforms initiated by the European Commission,[3] is currently working on a set of fallback provisions for interest rate benchmarks in derivatives transactions with the aim of providing legal certainty in cases where the usual benchmarks are no longer reliable or could give rise to market uncertainty. The fallbacks will need to achieve a fine balance between legal certainty and commercial expectations to protect the efficiencies of the markets. It remains to be seen whether these aims can be most efficiently achieved through legal documentation or market reform (or indeed both). ■

1 This assumes that neither "Compounding" nor "Flat Compounding" applies to the transaction.

2 Again, this assumes that neither "Compounding" nor "Flat Compounding" applies to the transaction.

3 Pursuant to the EU Benchmark Regulation, first published in September 2013.